

ADDENDUM

Federal Oversight of Regional Market

By ICF International

The primary allowance market will likely be regulated and monitored by respective WCI state and provincial environmental agencies in addition to other market monitors that are hired by the WCI participants. In addition, it is likely that the Commodities Futures Trading Commission, Federal Energy Regulatory Commission, and the Security and Exchange Commission, among others, will all have oversight responsibility for some portion of the WCI allowance market, primarily the secondary allowance markets.

The Federal Energy Regulatory Commission (FERC) provides economic regulation of the electricity utility industry, including financial transactions, wholesale rate regulation, transactions involving transmission of unbundled retail electricity, interconnection and wheeling of wholesale electricity, and ensuring adequate and reliable service. Regarding allowance accounting, electric public utilities and licensees within FERC jurisdiction are required to maintain their books and records in accordance with FERC's Uniform System of Accounts. While allowances are an accounting issue for FERC, not a ratemaking issue, it thus appears as if FERC will have some oversight into the WCI allowance market and can assess if market manipulation is occurring. In addition, the Energy Policy Act of 2005 gave FERC the authority to address any manipulative device and any entity participating in or affecting FERC's jurisdictional markets (primarily bulk electricity and interstate natural gas). FERC oversees power markets that involve extensive administrative adjustments to regional markets through market monitors. Since the prices of natural gas and wholesale electricity would be affected by the costs of emissions allowances, FERC might play a role in coordinating with another agency or agencies to assess whether the possibility of inter-market price manipulation exists in the WCI allowance market.

The Commodity Exchange Act provides the basis for federal regulation of "derivative" transactions in contracts based on commodity prices. Allowances are regulated by the Commodity Futures Trading Commission (CFTC) as exempt commodities under the Commodity Futures Modernization Act of 2000. The CFTC identifies four venues where exempt commodity trading under the Commodity Exchange Act can occur: (1) Designated Contract Markets, (2) Commercial Derivatives Transaction Execution Facilities (none currently in operation), (3) Exempt Commercial Markets (ECM), and (4) Over-the Counter (OTC)—not on a trading facility. Futures contracts and clearing services are provided by both New York Mercantile Exchange (NYMEX) and Chicago Climate Futures Exchange (CCFE) since both are Designated Contract Markets and are both regulated by the CFTC. For instance, RGGI allowances are already traded on the NYMEX and Chicago Climate Futures Exchange and it is likely that WCI allowances

would also be traded on these futures exchanges. It is likely, therefore, that the CFTC would have jurisdiction over any WCI allowances that are traded on a futures exchange. Specifically, the CFTC maintains a large trader reporting system and anyone controlling more than a specified number of contracts must report their positions daily. While this information is not made public it allows the CFTC to observe the accumulation of large positions held by a single trader with various brokerage firms. In addition, the CFTC monitors the deliverable supply of commodities, particularly as the expiration date of the futures contract draws near and the CFTC can take certain remedial steps if unusual shortages in delivery emerge.

The Securities and Exchange Commission (SEC) is another financial regulator that might have a role to play in ensuring that exchanges do not charge excessive fees for access to real-time price data. The SEC also has extensive experience and numerous programs set up to prevent and punish fraud. While much of the anti-fraud regulation takes place in a self-regulatory framework where exchanges are required to establish and enforce investor protection rules and rules to promote fair trading, the SEC has access to the records of all transactions so that they can monitor and prevent investor fraud. It is likely that similar programs would apply to trades in emissions allowances or derivatives executed on a regulated exchange, whether futures or securities.

In the Final Report on “Auction Design for Selling CO₂ Emission Allowances Under the Regional Greenhouse Gas Initiative,” the Auction Design team recommended that the RGGI market monitoring efforts take advantage of existing monitoring activities by federal and state agencies and other interested parties. Specifically they recommended that the RGGI states coordinate with the Federal Energy Regulatory Commission, the U.S. Environmental Protection Agency (EPA), the Independent System Operators, and the Community Futures Trading Commission (CFTC) in designing criteria for detecting market manipulation and for sharing of information regarding the performance of the allowance market and the detection of attempts to manipulate prices. These recommendations are equally appropriate for the WCI states since many of these federal and other interested parties have been involved in regulating the federal Title IV SO₂ trading program and have experience in overseeing existing markets.